

Stacey Sutay

Subject: FW: Statement 123 Reform: Accrue the bargain as it

-----Original Message-----

From: Calvin Johnson [mailto:chjohnson@mail.law.utexas.edu]

Sent: Wednesday, April 23, 2003 2:54 PM

To: Robert Herz

Cc: Michael Tovey

Subject: Statement 123 Reform: Accrue the bargain as it arises.

Dear Sir:

Zero costing for compensatory stock options is one of the grand failures of the discipline of accounting. Zero cost is not a good faith description of the option the CEO exercises at a \$100 million bargain. At zero cost, options are free, too cheap to meter and properly just left around for top management to pick up by the bushel. Management can steal the company from existing shareholders all while listing the compensatory cost as zero. Zero costing of \$100 million options is pretty good evidence that investors and shareholders have no friends in the accounting profession, even after Enron.

The accounting profession is not going to get to fix it with Black Scholes, however. As Holman Jenkins, Jr. says in this mornings Wall St. Journal (April 23, 2003 at A23),

[The expensing proposal] involves applying an esoteric mathematical operation to executive's stock option at the moment they are granted (i.e. before anyone knows whether they will be worth anything), for the sold purpose of whipping up a dubiously meaningful dollar figure that can be deducted from earnings as the 'cost' of the options.

Holman may be in bad faith because he probably wants zeroing costing, but he is right that expensing involves a debit of an unaccrued bargain before anyone knows anything about what the bargain is worth. The executive has not yet earned the bargain, and no one knows what it will be. The Black-Scholes approach is attempting to determine whether this is a high cost or a low cost option by looking to law of averages, when investors need to know not the averages but the results for the specific firm. The Black Scholes approach is debiting an unripe unaccrued contingency too early to get it right.

You are going to have to fix it by accruing the bargain on the option as it arises. That is the logical way that it done for earn-outs and compensation plans paid in cash. There is no rational distinction between a cash pay out and stock pay out. Accruing the bargain captures how much the option holder is earning per period. There is no need to make an arbitrary allocation of the unripe contingencies to years of the option.

Please let me know if I can be of any further assistance to you on this issue.

Calvin H. Johnson

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